KPMG
cutting through complexity

China alert

Issue 5 – April 2012

Shanxi Circular 698 Case – Largest so far

Matters discussed in this issue:

- Notice of the State Administration of Taxation (SAT) on Strengthening the Administration of Corporate Income Tax on Gains derived by Non-resident Enterprises from Equity Transfers, Guo Shui Han [2009] No. 698 (Circular 698)
- Reported case of the imposition, by the Jincheng local tax bureau, in the Shanxi province, of CIT on an indirect offshore disposal of an equity interest in a Chinese company, pursuant to Circular 698

Background

According to recent Chinese media reports, the Jincheng State Tax Bureau (Jincheng STB) in the Shanxi province recently collected tax in the amount of RMB 403 million from the indirect disposal of shares, in a Chinese coal enterprise, by a BVI company. The disposal was effected through the disposal, by the BVI company, of a Hong Kong company, which held the equity interest in the Chinese enterprise. The very substantial amount of tax involved makes this the single largest tax imposition in an offshore indirect transfer case to date, exceeding even the amount collected in the Master Kong Beverages case of 2011, in which RMB 306 million was collected, and the Evergrande case in January of this year, in which RMB 299 million was collected. The Jincheng case comes at a time when the PRC tax authorities are enforcing Circular 698 with vigour and draws attention to a number of recent developments of note in the application of the measure.

Circular 698 and the facts of the Jincheng case

A tax imposition pursuant to Circular 698 can be made based on the general anti-avoidance rule (GAAR) of the PRC Corporate Income Tax (CIT) Law. Offshore indirect transfer arrangements involving an abusive use of organisational forms, in respect of which the taxpayer is unable to demonstrate economic substance in the offshore company, may be re-characterised an as a direct disposal of the underlying equity interest in the Chinese company.

The Chinese coal enterprise at the centre of this case (Target) was originally established in Shanxi province in 2000 as the first large-scale Sino-foreign joint venture coal enterprise in China. A BVI company ('Transferor') built a 56 percent equity share in Target through a series of acquisition transactions over

several years. The Target shareholding was held by Transferor's wholly-owned Hong Kong subsidiary (Holdco).

In March 2011, the Jincheng STB became aware that Holdco had been transferred by Transferor to a coal industry holding company based in Hong Kong (Transferee) for a consideration of USD 669 million. It appears that the transaction was not reported to the Jincheng STB, as required under Circular 698. Once the Jincheng STB became aware of the transaction, it issued Notices of Tax Matters to Transferor and Transferee with a view to obtaining documentation relevant to the transfer, and carried out on-site inspections at Target's premises. The Jincheng STB apparently concluded that the transaction involved an abusive use of organisational forms and that Holdco exhibited insufficient economic substance as they proceeded to impose tax on the Transferor pursuant to Circular 698.

Having liaised with the tax representatives of Transferor for a period, and with demanded taxes remaining outstanding, Jincheng STB informed Transferee that they were to withhold the requisite amount of tax from the consideration as yet unpaid to Transferor. This led to Transferor finally agreeing to settle RMB 403 million in taxes.

The Jincheng case and the evolution of Circular 698

The RMB 403 million taken by the Jincheng STB is the largest Circular 698 settlement yet reported, and comes on the heels of reports that applications of Circular 698 are bringing in ever larger amounts. In the last year alone, tax collected by the PRC tax authorities nationwide on indirect equity transfers by non-resident enterprises totalled RMB 1.04 billion, having increased fourfold over the last year. In this regard, it has been noted that the global economic downturn caused a number of overseas enterprises to dispose of their China holdings, thereby driving up the number of Chinese equity disposals, both direct and indirect.

In the Jincheng case, the Jincheng STB leveraged its position vis-a-vis Transferor by instructing the Transferee that they would be obliged to withhold tax. Such a stance on the part of the tax authorities has been known to have been taken in previous cases although a charge to tax, pursuant to Circular 698, is specifically assessed directly on the transferor. Thus, the Jingcheng STB's adopted position appears to be grounded upon the general provisions of the PRC tax collection laws.

The references in the media reports to late payment surcharge and penalties being considered by the Jincheng STB is a matter of note, as it had been questioned whether the PRC tax authorities would, in practice, impose penalties on the transferor in addition to the tax collected for the purposes of Circular 698. If and when further case details emerge, the basis on which the penalties, if any, have been arrived at will be a matter of some interest to investors.

While it is not known precisely how the Jincheng STB obtained the information, which allowed them to take action against the Transferor, it is apparent that local and state tax authorities are making efforts to become more proficient at collecting information relevant to detection and pursuit in the context of Circular 698 tax impositions. The SAT and the State Administration for Industry and Commerce have established an information sharing platform for details of equity transfers in this year. Independently, at a regional level, the recently established co-operation mechanism between the Anhui State Tax Bureau and the Anhui Bureau of Commerce involves the latter supplying the former with equity transfer approval documents, and could well be adopted by other regions. Tax authorities are also increasingly showing their adeptness at collecting information from public sources (such as listed company annual reports and stock exchange announcements) to pursue claims.

Comparison with Vodafone case and developments in India

The parallel development of Circular 698 and the indirect offshore taxing approach taken by the Indian tax authorities has been highlighted by numerous commentators, given that the Vodafone case (as the most high profile attempt by the Indian tax authorities to tax an indirect offshore transfer) has, on occasions, been referred to as the 'inspiration' for Circular 698.

The Indian Supreme Court's decision in favour of Vodafone (reversing the earlier Bombay High Court verdict), regarding the non-taxability of an indirect offshore transfer of Indian telecoms assets, was taken in some quarters to be a decisive defeat for the application of a tax on indirect offshore disposals in India. Consequently, some questioned whether the isolation of China as the one country rigorously enforcing an indirect offshore transfer provision would lead the Chinese authorities to mellow the application of the provision.

However, the SAT will not necessarily change its course on the application of Circular 698 as a result of the decision in the Vodafone case. The reasons for this may be several fold: firstly, it can be surmised that the Indian Supreme Court's decision was driven by policy considerations (insofar as the previous Bombay High Court ruling was seen to have had cast a cloud over the attractiveness of India's investment climate) and carries little weight as a technical evaluation of international source taxing principles; secondly, it is also considered that China's indirect offshore transfer taxing provisions operate on a different basis to the technical grounds put forward by the Indian tax authorities, and as such, the Vodafone decision is of limited usefulness by way of guidance. Further, taxes imposed pursuant to Circular 698 are levied through a re-characterisation of the share transfer transaction under the Chinese GAAR, while India has no equivalent GAAR provisions in its tax laws at present. Lastly, the tax imposition in the Vodafone case was on Vodafone as withholding agent, while Circular 698 seeks to recover tax from the effective investor, being the taxpayer itself.

KPMG observations

The Jincheng case comes to light at a time when the PRC tax authorities have 'quickened the pace' in their use and application of Circular 698, with multiple recently reported cases involving substantial tax amounts coming to light. Such recent developments may be due to the PRC tax authorities enhancing their information collection approach and provides an interesting backdrop against the hardening approach to the taxation of offshore indirect disposals in India, the other major jurisdiction applying tax to offshore indirect disposals.

The latest developments in India may have given succour to the SAT in resisting any call for softening the application of Circular 698, as the Indian government is in the process of introducing retrospective legislation, which would simply deem gains on sales of shares in offshore incorporated enterprises, which derive their value substantively from Indian assets to be sourced in India (effectively overturning the decision of the Indian Supreme Court in the Vodafone case). This appears to go even beyond Circular 698 in terms of its potential scope of application, as a tax charge under Circular 698 requires a finding of abusive use of organisational forms on GAAR grounds.

The latest Jincheng case, together with the Vodafone decision and related legislative developments in India, are matters of keen interest for investors who would be well advised to continue to monitor further developments on this front.

Contact us

Khoonming Ho
Partner in Charge, Tax
China and Hong Kong SAR
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Beijing/Shenyang
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Qingdao
Vincent Pang
Tel. +86 (532) 8907 1728
vincent.pang@kpmg.com

Shanghai/Nanjing
Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Hangzhou
Martin Ng
Tel. +86 (571) 2803 8081
martin.ng@kpmg.com

Chengdu
Anthony Chau
Tel. +86 (28) 8673 3916
anthony.chau@kpmg.com

Guangzhou
Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Fuzhou/Xiamen
Jean Jin Li
Tel. +86 (592) 2150 888
jean.j.li@kpmg.com

Shenzhen
Eileen Sun
Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Hong Kong
Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

Northern China
David Ling
Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Vaughn Barber
Tel. +86 (10) 8508 7071
vaughn.barber@kpmg.com

Roger Di
Tel. +86 (10) 8508 7512
roger.di@kpmg.com

John Gu
Tel. +86 (10) 8508 7095
john.gu@kpmg.com

Jonathan Jia
Tel. +86 (10) 8508 7517
jonathan.jia@kpmg.com

Paul Ma
Tel. +86 (10) 8508 7076
paul.ma@kpmg.com

Vincent Pang
Tel. +86 (10) 8508 7516
+86 (532) 8907 1728
vincent.pang@kpmg.com

Michael Wong
Tel. +86 (10) 8508 7085
michael.wong@kpmg.com

Irene Yan
Tel. +86 (10) 8508 7508
irene.yan@kpmg.com

Leonard Zhang
Tel. +86 (10) 8508 7511
leonard.zhang@kpmg.com

Tracy Zhang
Tel. +86 (10) 8508 7509
tracy.h.zhang@kpmg.com

Abe Zhao
Tel. +86 (10) 8508 7096
abe.zhao@kpmg.com

Catherine Zhao
Tel. +86 (10) 8508 7515
catherine.zhao@kpmg.com

Kevin Lee
Tel. +86 (10) 8508 7536
kevin.lee@kpmg.com

Eric Zhou
Tel. +86 (10) 8508 7610
ec.zhou@kpmg.com

Central China
Lewis Lu
Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Anthony Chau
Tel. +86 (21) 2212 3206
+86 (28) 8673 3916
anthony.chau@kpmg.com

Cheng Chi
Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Chris Ho
Tel. +86 (21) 2212 3406
chris.ho@kpmg.com

Lily Kang
Tel. +86 (21) 2212 3359
lily.kang@kpmg.com

Sunny Leung
Tel. +86 (21) 2212 3488
sunny.leung@kpmg.com

Martin Ng
Tel. +86 (21) 2212 2881
+86 (571) 2803 8081
martin.ng@kpmg.com

Yasuhiko Otani
Tel. +86 (21) 2212 3360
yasuhiko.otani@kpmg.com

John Wang
Tel. +86 (21) 2212 3438
john.wang@kpmg.com

Jennifer Weng
Tel. +86 (21) 2212 3431
jennifer.weng@kpmg.com

Lachlan Wolfers
Tel. +86 (21) 2212 3515
lachlan.wolfers@kpmg.com

Grace Xie
Tel. +86 (21) 2212 3422
grace.xie@kpmg.com

Zichong Xu
Tel. +86 (21) 2212 3404
zichong.xu@kpmg.com

William Zhang
Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

Cheng Dong
Tel. +86 (21) 2212 3605
cheng.dong@kpmg.com

David Huang
Tel. +86 (21) 2212 3605
david.huang@kpmg.com

Dylan Jeng
Tel. +86 (21) 2212 3080
dylan.jeng@kpmg.com

Amy Rao
Tel. +86 (21) 2212 3208
amy.rao@kpmg.com

Michelle B. Zhou
Tel. +86 (21) 2212 3458
michelle.b.zhou@kpmg.com

Southern China
Eileen Sun
Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Angie Ho
Tel. +86 (755) 2547 1276
angie.ho@kpmg.com

Jean Jin Li
Tel. +86 (755) 2547 1128
+86 (592) 2150 888
jean.j.li@kpmg.com

Jean Ngan Li
Tel. +86 (755) 2547 1198
jean.li@kpmg.com

Lilly Li
Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Kelly Liao
Tel. +86 (20) 3813 8668
kelly.liao@kpmg.com

Bin Yang
Tel. +86 (20) 3813 8605
bin.yang@kpmg.com

Hong Kong
Ayesha M. Lau
Partner in Charge, Tax
Hong Kong SAR
Tel. +852 2826 7165
ayesha.lau@kpmg.com

Chris Abbiss
Tel. +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern
Tel. +852 2826 7166
darren.bowdern@kpmg.com

Alex Capri
Tel. +852 2826 7223
alex.capri@kpmg.com

Barbara Forrest
Tel. +852 2978 8941
barbara.forrest@kpmg.com

Nigel Hobler
Tel. +852 2143 8784
nigel.hobler@kpmg.com

Charles Kinsley
Tel. +852 2826 8070
charles.kinsley@kpmg.com

John Kondos
Tel. +852 2685 7457
john.kondos@kpmg.com

Alice Leung
Tel. +852 2143 8711
alice.leung@kpmg.com

Curtis Ng
Tel. +852 2143 8709
curtis.ng@kpmg.com

Kari Pahlman
Tel. +852 2143 8777
kari.pahlman@kpmg.com

John Timpany
Tel. +852 2143 8790
john.timpany@kpmg.com

Wade Wagatsuma
Tel. +852 2685 7806
wade.wagatsuma@kpmg.com

Jennifer Wong
Tel. +852 2978 8288
jennifer.wong@kpmg.com

Christopher Xing
Tel. +852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung
Tel. +852 2143 8753
karmen.yeung@kpmg.com

kpmg.com/cn